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IN THE

Supreme Court of the United States

October Term, 1967

No. 604

ROYALTON STONE CORPORATION, FRONTIER STONE PRODUCTS, INC., HOLMAN O'CONNOR, and MARY W. O'CONNOR, JAMES M. SWITZER and DOROTHEA W. SWITZER,

Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit.

Opinion Below

The opinion of the United States Court of Appeals for the Second Circuit is reported at ___ F. 2d ____ (Nos. 31056-62, 6/14/67) and is reprinted in the Appendix, *infra*, pp. 7-12.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit was entered on June 14, 1967. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254.

Question Presented

Whether individual Petitioners retained an economic interest in sand and gravel under a purported agreement of sale between the individual Petitioners and corporate Petitioners for a consideration fixed per unit of sand and gravel extracted, thereby precluding capital gains treatments of amounts received by the individual Petitioners under the agreements, and giving rise to deductions by the corporate Petitioners for royalties paid.

Statutes and Regulations Involved

The statutes and regulations involved are Sections 61 and 611 of the Internal Revenue Code of 1954, 26 U. S. C. Sections 61 and 611, and Treasury Regulations Sections 1.61-6, 1.61-8, 1.611-1(b) and 26 C. F. R. Sections 1.61-6, 1.61-8, 1.611-1(b).

Statement of the Case

In December 5, 1962 and on April 19, 1963, the Commissioner of Internal Revenue sent to Petitioners,[1] by registered mail, notices of deficiency, advising them of the determination by the Commissioner of deficiencies in their Federal Income Tax liabilities for the calendar years and fiscal years ending 1958, 1959, 1960 and 1961. On March 1, 1963, with respect to the notices of deficiency of Decem-

[1] Mary W. O'Connor and Dorothea W. Switzer, the wives of Holman O'Connor and James M. Switzer, were included as parties to the action solely because of the filing of joint returns, and they had no active part in the business transaction involved herein.

ber 5, 1962, and on July 16, 1963, with respect to the notices of deficiency of April 19, 1963, Petitioners filed with the Tax Court of the United States petitions for redeterminations of such deficiencies.

The individual Petitioners (hereinafter referred to as the "individuals") were the owners of three tracts of property containing quarriable materials. They entered into written agreements with the corporate Petitioners (hereinafter referred to as the "corporations"), each of which provided that the individuals agreed to sell and the corporation agreed to purchase the described tract of land, and under which the corporations were required to enter into immediate possession for the purpose of removing sand, gravel, stone and other materials for a purchase price of $0.20 per ton of materials quarried and removed. The agreement in each case provided that when the corporation completed its quarrying operations and paid the purchase price, the individuals would execute deeds and deliver title to the described premises.[2] The two corporations were owned entirely by the individuals. The corporations began quarrying and made payments under the terms of these agreements to the individuals in the taxable years in question.

The Respondent determined deficiencies in the income taxes of the individuals for the years in question by holding that the amounts constituted royalty income rather than the proceeds of the sale of capital assets as reported. The Respondent adjusted the corporations' income tax to disallow the percentage depletion as claimed, but to allow a

[2] The agreement with Royalton Stone Corporation was dated April 15, 1957. The agreements with Frontier Stone Products, Inc. were dated April 15, 1957 and June 26, 1959. The former covered 6½ acres of an approximate 53-acre plot owned by the individuals who continued to own the remaining property. Each of the agreements was in the same form except for the description of the property. The relevant part of the text of one such agreement is set forth in the Opinion of the Second Circuit (Appendix, *infra*, pp. 9 and 10).

deduction for royalties paid. The Tax Court in a decision by a single member and without review, sustained the Respondent. As the result of a Rule 50 computation in the Tax Court, it was determined that the individual Petitioners had deficiencies in income taxes in each of the years involved, but that the corporate Petitioners had overpaid their income taxes in each year involving the corporate Petitioners.

The Second Circuit affirmed the decision of the Tax Court in a decision entered June 14, 1967, on the ground that the individual Petitioners retained an economic interest under the agreements.

Reason for Granting the Writ

In determining that the individual Petitioners retained an economic interest in sand and gravel under agreements providing for the sale of land with the consideration fixed per unit of sand and gravel extracted, the Court of Appeals for the Second Circuit made an interpretation of "economic interest" that is in conflict with the decisions of this Court and other Circuits.

In the past several years, the Courts of Appeals for the various Circuits have considered a great number of cases involving the question of whether capital gain rather than ordinary income is realized under contracts providing for the sale or removal of dirt, sand, gravel, stone or similar hard minerals (*Linehan vs. Commissioner,* 297 F. 2d 276 (CA 1, 1961), *Barker vs. Commissioner,* 250 F. 2d 195 (CA 2, 1957), *Laudenslager vs. Commissioner,* 305 F. 2d 686 (CA 3, 1962), *Crowell Land and Mineral Corporation vs. Commissioner,* 242 F. 2d 864 (CA 5, 1957), *Albritton vs. Commissioner,* 248 F. 2d 49 (CA 5, 1957), *U. S. vs. Witte,* 306 F. 2d 81 (CA 5, 1962), *Freund vs. U. S.,* 367 F. 2d 776 (CA

7, 1966), *Commissioner vs. Remer,* 260 F. 2d 337 (CA 8, 1958), *Gowans vs. Commissioner,* 246 F. 2d 448 (CA 9, 1957), *Wood vs. U. S.,* 377 F. 2d 300 (CA 5, 1967), *Peeler vs. U. S.,* 377 F. 2d 531 (CA 5, 1967), and *Green vs. U. S.,* 377 F. 2d 550 (CA 5, 1967).)

The critical questions presented to these Courts have been (1) whether the rules applicable to oil and gas contracts are equally applicable to hard mineral contracts, (2) the extent to which the form of consideration affects the character of the contract, and (3) the significance of the language used in the agreement.

On August 9, 1967, there were filed with the Supreme Court of the United States, petitions for writs of certiorari in *Wood vs. U. S., supra,* and *Peeler vs. U. S., supra,* involving these issues. These petitions are presently pending, and demonstrate that there is a conflict among the Courts of Appeals and this Court on these issues.

The decision of the Second Circuit Court of Appeals in the Instant Case involves these issues. Petitioners request a writ of certiorari for the reasons set forth in the petitions in *Wood vs. U. S., supra,* and *Peeler vs. U. S., supra.*

In addition to such reasons, the Petitioners assert that there is a conflict between the Court of Appeals for the Second Circuit in the Instant Case and the Court of Appeals for the Fifth Circuit in *Crowell Land and Mineral Corporation vs. Commissioner, supra.*

In *Crowell* the Court of Appeals for the Fifth Circuit held that the taxpayer was entitled to capital gain treatment on the sale of sand and gravel for a consideration measured per unit extracted, as in the Instant Case. The *Crowell* case was distinguished by the same Court of Appeals in *Albritton vs. Commissioner, supra,* and in *Wood*

vs. U. S., supra (petition for certiorari pending), on the ground that in *Crowell* the wording of the instrument was that of a contract of sale. The same is clearly so in the Instant Case.

The issue is an important and difficult one as is indicated by the number of cases reaching the Courts. A decision by the United States Supreme Court in the Instant Case and in the above-cited cases in which petitions for certiorari are pending will significantly assist in the uniform application of the tax law throughout the United States.

Conclusion

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX

Opinion

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 443-449—September Term, 1966.
(Argued May 11, 1967 Decided June 14, 1967.)
Docket Nos. 31056-62

ROYALTON STONE CORPORATION, FRONTIER STONE PRODUCTS, INC., HOLMAN O'CONNOR, MARY W. O'CONNOR, JAMES M. SWITZER and DOROTHEA W. SWITZER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before: SMITH, KAUFMAN and HAYS,

Circuit Judges.

Petitions for review of decisions of the Tax Court, Marion J. Harron, *Judge*, 25 CCH Tax Ct. Mem. 1966-109, holding that certain payments received by taxpayers were not entitled to capital gains treatment because they represented royalty payments and were not made for the purchase of taxpayers' property.

Affirmed.

Albert R. Mugel, Buffalo, New York (Timothy C. Leixner, Jaeckle, Fleischmann, Kelly, Swart & Augspurger, on the brief), for Petitioners.

Jonathan S. Cohen, Washington, D. C. (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson and Grant W. Wiprud, Attorneys, Department of Justice, Washington, D. C., on the brief), for Respondent.

HAYS, *Circuit Judge:*

These are petitions for review of decisions of the Tax Court holding that certain payments received by the taxpayers[1] were ordinary income, to wit, royalty payments on minerals extracted from taxpayers' property, and not payments of the purchase price for the sale of the property. We affirm the decisions of the Tax Court.

Royalton Stone Corporation and Frontier Stone Products, Inc. are engaged principally in the business of quarrying stone for road building. The stock of the two corporations is owned fifty percent each by the taxpayers Switzer and O'Connor.

Switzer and O'Connor each owned a half interest in three parcels of real property. During the years 1957 to 1959 Switzer and O'Connor executed agreements with Royalton and Frontier under which the corporations were to

[1] James M. Switzer and Holman O'Connor are herein referred to as petitioners and taxpayers. Their wives are included as parties to the action solely because of the filing of joint returns. The Commissioner had filed protective petitions for review to assure that the corporate petitioners will not be permitted to deduct the payments in question if the decisions of the Tax Court are reversed.

quarry the deposits of stone and other materials on the real property.

Since the agreements were substantially identical, it is sufficient to set forth as an example the relevant parts of the agreement executed by Switzer and O'Connor with Frontier in respect to one of the parcels of real property:

> 1. The parties of the first part [O'Connor and Switzer] agree to sell, and the party of the second part [Frontier] agrees to purchase the premises situate in the City of Lockport, in the County of Niagara and State of New York, particularly described in a certain deed dated the 1st day of October, 1956, duly recorded in the Office of the Clerk of the County of Niagara, as follows:
>
> [Land Description]
>
> 2. Said premises are to [be] conveyed by the parties of the first part by Covenant against Grantor Deed conveying good and marketable title to the premises, free from all encumberances upon payment of the purchase price to be fixed and paid in the following manner, to-wit: The party of the second part shall enter into immediate possession of the premises hereinabove desribed for the purpose of quarrying and removing therefrom sand, gravel, stone and other materials useable in its business and shall pay to the parties of the first part, on or before the 31st day of December of each year after date, the sum of twenty cents (20¢) per ton of materials so quarried and removed during the preceding period.
>
> 3. When the party of the second part has completed its quarrying operations on said property and paid on account of the purchase price of the premises, the

full sum of twenty cents (20¢) per ton for materials quarried and removed as hereinabove set forth, the parties of the first part shall thereupon execute and deliver title to the premises in the manner hereinbefore described.

4. The parties of the first part shall pay all taxes and assessments levied against said premises prior to the delivery of the deed and the party of the second part shall indemnify and harmless save the parties of the first part of and from any and all liability, in law and equity, for loss or damage to any person or property arising out of its operations on the described premises from and after the date hereof.

It is the contention of the Commissioner that the amounts paid by the corporations to the taxpayers at the rate of 20 cents per ton for the minerals removed represented royalty payments and therefore ordinary income. The taxpayers urge that the payments were the purchase price for the sale of the land and should receive capital gains treatment.

The provisions of the agreements designating the transactions as "purchases" and "sales" are, of course, not conclusive. In order to determine the tax consequence of the transactions, we must look to their essential character rather than their form. *Commissioner v. P. G. Lake, Inc.*, 365 U. S. 260 (1958); *Anderson v. Helvering*, 310 U. S. 404, 411 (1940).

Upon close examination the incidents of the transactions into which the parties entered prove to be a licensing arrangement with provisions for royalty payments rather than a sale of the minerals. The taxpayers merely licensed the corporations to remove the minerals in return for a

share of the proceeds of their sale. The only property transferred to the corporations by the agreements was the right to quarry the minerals. There was no present conveyance or anything else.

The taxpayers expressly reserved legal title until some indefinite future time and, as an appropriate incident of ownership, were obliged to pay taxes and assessments on the property. It is clear that they continued to own the minerals until they were removed truckload by truckload.

The land itself was acquired by the taxpayers for the sole purpose of having the corporations quarry the minerals. The exploitation of the minerals was the primary objective of the entire series of transactions.

The taxpayers were, of course, dealing with themselves and thus could have the corporations quarry whatever amount they wanted to have quarried. Nothing in the agreements indicates an intent to buy and sell any given amount of minerals. There was no obligation to pay for anything except the amount which was quarried.

There was no requirement that all the minerals be extracted and the agreements fixed no maximum or minimum amount which the corporations were to quarry. In fact the corporations had no affirmative duty to mine at all. They could terminate the quarrying at any time without any liability except to pay 20 cents a ton for the minerals already quarried. If the corporations failed or refused to quarry, the agreements provide for no obligation to pay any amount whatever.

The corporations were not required to make any initial payment.

"We have said that the instrument should be construed as a sale when a large cash payment was made with a reserved payment that could be satisfied by future sales

> of the transferred property without extraction of the oil . . . On the other hand, we have construed an assignment of oil leases for cash and a deferred payment, 'payable out of oil only, if, as and when produced,' as the reservation of an economic interest in the oil—not a sale. *Thomas v. Perkins,* 301 U. S. 655." *Burton-Sutton Oil Co. v. Commissioner,* 328 U. S. 25, 35-36 (1946).

No fixed purchase price was paid or payable at any time. If there was no quarrying the taxpayers would receive nothing. The only obligation of the corporations was to pay 20 cents a ton for whatever amount they removed. The agreements provided for no additional consideration for the conveyance of the land.

The arrangement into which the taxpayers entered differs in dispositive respects from the arrangement in *Crowell Land & Mineral Corporation v. Commissioner,* 242 F. 2d 864 (5th Cir. 1957) on which taxpayers seek to rely. In *Crowell* the transferee of the land was given five years in which to extract the minerals and was required to make a down payment and to pay a fixed minimum over a period of time, regardless of the amount extracted. Unlike the present case there was thus provision for a fixed amount over a fixed period of time. The result in *Crowell* is consonant with the decisions in *Barker v. Commissioner,* 250 F. 2d 195 (2d Cir. 1957), where there was an obligation to pay no matter what the extent of the minerals extracted, and in *Gowans v. Commissioner,* 246 F. 2d 448 (9th Cir. 1957), where the purchaser was required to quarry a fixed amount. The present case is consistent with the recent decision of the Fifth Circuit in *Wood v. United States,* No. 22693 (May 11, 1967).

Affirmed.

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 604

ROYALTON STONE CORPORATION, FRONTIER STONE PRODUCTS, INC., HOLMAN O'CONNOR AND MARY W. O'CONNOR, JAMES M. SWITZER AND DOROTHEA W. SWITZER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question is whether payments received by the individual petitioners [1] for minerals removed from their land were capital gains or depletable ordinary income. The individual petitioners entered into purported "sales" agreements with the corporate petitioners, their wholly-owned operating corporations. The corporations were to quarry and remove sand, gravel, stone and associated materials from the indi-

[1] Since the individual petitioner-husbands were the only active parties to the transactions involved, they are referred to herein as "the individual petitioners".

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viduals' land and pay 20 cents per ton removed. The corporations were not obligated to extract any specific amount of the minerals or to pay any initial sum or guaranteed minimum sum; they could cease operations at any time with no obligation other than to pay at the specified rate for minerals removed. When and if all deposits were extracted, the land, which would then be virtually worthless, was to be conveyed to the corporations.

Petitioners treated the transaction as giving rise to capital gains to the individuals and as not giving the corporations the right to claim business deductions. The Commissioner determined deficiencies in the individuals' tax liability on the ground that the proceeds were depletable ordinary income. In a suit for a redetermination, the individual petitioners contended that the tonnage payments were capital gain from a sale. The court of appeals, affirming the Tax Court, held that the payments were in substance royalties paid pursuant to a licensing arrangement, taxable to the individual petitioners as ordinary income subject to the depletion allowance.[2]

1. The same basic issue was decided in favor of the government by the Fifth Circuit in *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5). The taxpayers in *Wood*, and in a companion case, *United States* v. *Peeler*, 377 F. 2d 531 (C.A. 5), have filed petitions

[2] The corollary of this holding is that the corporations are entitled to deduct the tonnage payments in full as business expenses, and the Tax Court has made appropriate adjustments in the tax liability of the corporate petitioners for the taxable years.

for writs of certiorari in Nos. 471 and 475, this Term. The Commissioner is filing memoranda in opposition to those petitions at the same time as this memorandum is filed.

In the instant case, petitioners assert (Pet. 5) that certiorari should be granted for the reasons set forth in the petitions in *Wood* and *Peeler*. For our answers to those arguments, we refer the Court to our oppositions in those cases.[3]

2. Petitioners in addition contend (Pet. 5–6) that the decision here is in conflict with *Crowell Land & Min. Corp.* v. *Commissioner*, 242 F. 2d 864, where the Fifth Circuit held that a transfer of operating rights in hard minerals for payments measured by a per ton royalty was a sale in substance as well as in form, and entitled to capital gains treatment. But that case is inapposite, since, as the Second Circuit noted here (Pet. 12) the operating company in *Crowell* was required to pay a fixed amount over a fixed period, regardless of extraction.

Moreover, in its decision in *Wood* v. *United States, supra*, the Fifth Circuit has substantially restricted the precedential reach of *Crowell*. More particularly, in *Wood* the Fifth Circuit disapproved the strong emphasis in *Crowell* on the wording of the instrument as a contract of sale, stating that form is not "properly determinative of tax consequences under the economic interest test", and it also rejected *Crowell* as any precedent for the proposition that a

[3] Copies of those oppositions are being served on petitioners' counsel.

transferor of operating rights does not retain his "economic interest" where his royalty is measured by a fixed per ton royalty. (377 F. 2d at 311.) This restriction of *Crowell* was indeed required by this Court's prior decisions. For example, it is said in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 32:

> Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place. *Palmer* v. *Bender,* 287 U.S. 551, 557, 558.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ROYALTON STONE CORPORATION, FRONTIER STONE PRODUCTS, INC., HOLMAN O'CONNOR AND MARY W. O'CONNOR, JAMES M. SWITZER AND DOROTHEA W. SWITZER

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit, but only if this Court grants respondents' petition for certiorari, filed on September 12, 1967, No. 604, this Term, which seeks review of the same judgment.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 18–54)[1] is not officially reported. The opinion of the court of appeals (Pet. 7–12) is reported at 379 F. 2d 298.

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[1] "R" refers to the appendix to respondents' brief in the court of appeals. "Pet." refers to the petition for certiorari in No. 604, this Term.

279-721—67——1

JURISDICTION

The judgment of the court of appeals was entered on June 14, 1967. On September 14, 1967, Mr. Justice Harlan extended the time for filing this protective petition to and including October 26, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the amounts that the corporate respondents paid the individual respondents for minerals removed from the latter's land were depletable ordinary income of the individuals and therefore properly allowed as a business expense deduction of the corporations.

STATEMENT

The individual respondents entered into purported sales agreements with the corporate respondents, their wholly-owned corporations. The corporations were to quarry and remove sand, gravel, stone and associated materials from the individuals' land and pay 20 cents per ton removed. Respondents treated the transaction as giving rise to capital gains to the individuals and as not giving the corporations the right to claim the payments as business deductions. The Commissioner determined deficiencies in the individuals' tax liability on the ground that the proceeds were depletable ordinary income. In a suit for redetermination, the Tax Court sustained the Commissioner's position as to the individuals and allowed the corporations to deduct the tonnage payments in full as business expense. The court of appeals affirmed. Respondents here seek review of that judgment in No. 604, this Term.

REASON FOR GRANTING THE WRIT

The purpose of this petition for certiorari is to preserve the Commissioner's interest in securing consistent treatment of the tax consequences of this transaction to the individuals and the corporations. If the courts below correctly held, as we believe, that the tonnage payments were depletable ordinary income to the individuals, then the corporations were properly allowed deductions for the payments. If, however, this Court should grant the petition in No. 604, this Term, and hold that the individuals were entitled to capital gains treatment, the Court should at the same time hold that the corporations were not entitled to business deductions.

Therefore, if this Court should allow the individual respondents' petition in No. 604, this Term, it should also allow the instant petition in order to protect the public revenues with respect to the tax liability of the corporations.

CONCLUSION

If certiorari be granted in No. 604, this Term, this petition should also be granted; but if certiorari be denied in No. 604, this petition should be denied.

Respectfully submitted.

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JONATHAN S. COHEN,
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